

**Letter of Findings Number: 01-20110213
Individual Income Tax
For the Years 2007-2008**

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ISSUE

I. Individual Income Tax – Research Expense Credit.

Authority: IC § 6-3.1-4-1 et seq.; IC §6-3.1-4-4; IC § 6-8.1-5-4; I.R.C. § 41; Treas. Reg. § 1.41-2; Treas. Reg. § 1.41-4; Cohan v. Comm'r, 39 F.2d 540 (2^d Cir. 1930); Lerch v. Comm'r, 877 F.2d 624 (7th Cir. 1989); U.S. v. McFaddin, 570 F.3d 672 (5th Cir. 2009).

Taxpayer protests the assessment of individual income tax based on the disallowance of a research expense credit.

STATEMENT OF FACTS

Taxpayer is a shareholder in an S corporation. The S corporation owned a subsidiary (Business) which operated in Indiana. The Indiana Department of Revenue ("Department") audited Business. Business had claimed an increase in research activities for 2007 and 2008, which resulted in a research expense credit. However, the Department determined that a portion of Business' claimed research expenses were not permitted and redetermined the research expense credit. Taxpayer claimed the credit as an S corporation shareholder. The resulting disallowance of the credit resulted in a proposed tax assessment against Taxpayer. Taxpayer protested the assessment, the Department conducted an administrative hearing, and this Letter of Findings results. Further information will be supplied as necessary.

I. Individual Income Tax – Research Expense Credit.

DISCUSSION

Taxpayer protests the disallowance of the credit for increasing research expenses.

Under IC § 6-3.1-4-1 et seq., taxpayers are permitted a credit for increasing research expenses. IC § 6-3.1-4-4 provides that federal law is "applicable to the interpretation and administration by the department of the credit provided by this chapter." Further, the key definitions relevant to the determination of the credit—"base amount" and "qualified research expense"—are determined by reference to I.R.C. § 41.

I.R.C. § 41(d) provides:

(d) Qualified research defined.--For purposes of this section--

(1) In general.--The term "qualified research" means research--

(A) with respect to which expenditures may be treated as expenses under section 174,

(B) which is undertaken for the purpose of discovering information--

(i) which is technological in nature, and

(ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and

(C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3).

Such term does not include any activity described in paragraph (4).

(2) Tests to be applied separately to each business component.--For purposes of this subsection--

(A) In general.--Paragraph (1) shall be applied separately with respect to each business component of the taxpayer.

(B) Business component defined.--The term "business component" means any product, process, computer software, technique, formula, or invention which is to be--

(i) held for sale, lease, or license, or

(ii) used by the taxpayer in a trade or business of the taxpayer.

(C) Special rule for production processes.--Any plant process, machinery, or technique for commercial production of a business component shall be treated as a separate business component (and not as part of the business component being produced).

(3) Purposes for which research may qualify for credit.--For purposes of paragraph (1)(C)--

(A) In general.--Research shall be treated as conducted for a purpose described in this paragraph if it relates to--

(i) a new or improved function,

(ii) performance, or

(iii) reliability or quality.

(B) Certain purposes not qualified.--Research shall in no event be treated as conducted for a purpose

described in this paragraph if it relates to style, taste, cosmetic, or seasonal design factors.

(4) Activities for which credit not allowed.--The term "qualified research" shall not include any of the following:

- (A) Research after commercial production.--Any research conducted after the beginning of commercial production of the business component.
- (B) Adaptation of existing business components.--Any research related to the adaptation of an existing business component to a particular customer's requirement or need.
- (C) Duplication of existing business component.--Any research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component.
- (D) Surveys, studies, etc.--Any--
 - (i) efficiency survey,
 - (ii) activity relating to management function or technique,
 - (iii) market research, testing, or development (including advertising or promotions),
 - (iv) routine data collection, or
 - (v) routine or ordinary testing or inspection for quality control.
- (E) Computer software.--Except to the extent provided in regulations, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer, other than for use in--
 - (i) an activity which constitutes qualified research (determined with regard to this subparagraph), or
 - (ii) a production process with respect to which the requirements of paragraph (1) are met.
- (F) Foreign research.--Any research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States.
- (G) Social sciences, etc.--Any research in the social sciences, arts, or humanities.
- (H) Funded research.--Any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

Two issues are disputed by Taxpayer.

A. Research after Commercial Production and Duplication of Existing Business Components.

Taxpayer protests the disallowance of research expenses related to products already sold to customers. The issue is whether the expenses in question were for "research conducted after the beginning of commercial production of the business component" under I.R.C. § 41(d)(4)(A) or were for "duplication of existing business components" under I.R.C. § 41(d)(4)(C).

I.R.C. § 41(d)(4)(A) provides generally that research expenses for "research conducted after the beginning of commercial production of the business component" are not qualified expenses for purposes of computing the research expense credit. Treas. Reg. § 1.41-4(c) explains:

- (2) Research after commercial production--(i) In general. Activities conducted after the beginning of commercial production of a business component are not qualified research. Activities are conducted after the beginning of commercial production of a business component if such activities are conducted after the component is developed to the point where it is ready for commercial sale or use, or meets the basic functional and economic requirements of the taxpayer for the component's sale or use.
- (ii) Certain additional activities related to the business component. The following activities are deemed to occur after the beginning of commercial production of a business component--
 - (A) Preproduction planning for a finished business component;
 - (B) Tooling-up for production;
 - (C) Trial production runs;
 - (D) Trouble shooting involving detecting faults in production equipment or processes;
 - (E) Accumulating data relating to production processes; and
 - (F) Debugging flaws in a business component.
- (iii) Activities related to production process or technique. In cases involving development of both a product and a manufacturing or other commercial production process for the product, the exclusion described in section 41(d)(4)(A) and paragraphs (c)(2)(i) and (ii) of this section applies separately for the activities relating to the development of the product and the activities relating to the development of the process. **For example, even after a product meets the taxpayer's basic functional and economic requirements, activities relating to the development of the manufacturing process still may constitute qualified research, provided that the development of the process itself separately satisfies the requirements of section 41(d) and this section, and the activities are conducted before the process meets the taxpayer's basic functional and economic requirements or is ready for commercial use. (Emphasis added.)**

...

(3) Adaptation of existing business components. Activities relating to adapting an existing business component to a particular customer's requirement or need are not qualified research. This exclusion does not

apply merely because a business component is intended for a specific customer.

(4) Duplication of existing business component. Activities relating to reproducing an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information about the business component are not qualified research. This exclusion does not apply merely because the taxpayer examines an existing business component in the course of developing its own business component.

For the products at issue in this protest, Business performed three separate but somewhat related actions. First, Business rewrote certain computer programs in new languages. Second, Business added new functions to its already-marketed programs due to changes in law requiring additional data fields. Third, Business corrected various issues in its programs to permit proper report generation.

Business' process of converting a program from one programming language to another language is "reproducing an existing business component" under Treas. Reg. § 1.41-4(c)(4) because it is the conversion of a program from a previously-completed program to a new language. Thus, the expenses related to this aspect of Business' process do not constitute "qualified research expenses" within the meaning of Indiana and federal law.

However, the work in adding new, mandated fields, adding additional remote access features, and other substantive features in the software required a process of experimentation to ensure that the data was properly formatted, that the addition of new fields and features were integrated with the previously-written components of the software, and that the portions of the program could be used on different platforms. Though the line of software was an existing business component, the addition of new fields is analogous to the examples provided under Treas. Reg. § 1.41-4(c) related to the production or development of a new product, the expenses of which can be qualified research expenses. The processes of adding the new fields and features, integrating the new features with the existing program (or portions thereof), determining the proper programming languages for the new features, and determining errors in the programs prior to the commercial release of the new version constituted qualified research within the meaning of federal and Indiana law.

Business also raised the issue of repairing a problem with users entering invalid data and the effects on report generation resulting from the invalid data. These activities constitute troubleshooting and debugging within the meaning Treas. Reg. § 1.41-4(c)(2)(ii) and the associated expenses are not permitted as qualified research expenses.

B. Required Substantiation.

Business asserts that the auditor's denial of the research expense credit was improper because of the type of substantiation provided. The issue is whether Business' substantiation was sufficient.

Under IC § 6-8.1-5-4(a):

Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts, and canceled checks.

Business cites to *Cohan v. Comm'r*, 39 F.2d 540 (2^d Cir. 1930) and *U.S. v. McFaddin*, 570 F.3d 672 (5th Cir. 2009) for the proposition that specific types of documentation are not necessarily required to substantiate a claimed expense or deduction. In particular, Business asserts that an estimate of expenses is permitted, citing the *Cohan* case. Business further cites to the specific documentation requirements set forth under I.R.C. § 274 as evidence that a specific type of recordkeeping is not required to substantiate qualified research expenses.

In *Cohan*, the taxpayer claimed various expenses on his personal income tax return. Upon audit on the taxpayer's return, the Bureau of Internal Revenue ("BIR"), which was the predecessor of the current Internal Revenue Service) acknowledged that a portion of the expenses were incurred; however, the BIR disallowed all of the expenses claimed by the taxpayer. The court held that:

Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent.

Cohan, 39 F.2d at 543-544. However, per *Lerch v. Comm'r*, 877 F.2d 624, 629 n.9 (7th Cir. 1989):

It appears that the only time some estimate must be made is in the classic *Cohan* situation, where the taxpayer claims a deduction, and the Commissioner recognizes that the taxpayer has a legitimate claim to the deduction, only the taxpayer has failed to establish exactly how much that deduction ought to be.

(Citations omitted.)

Further, as noted in *Lerch*, the *Cohan* rule has been narrowed in cases where taxpayer could have and should have maintained records to substantiate the deduction in question. *Id.* at 628.

Even assuming that Business' circumstances permit a *Cohan*-type estimate, much of the information provided by Business lists a percentage of employee's time spent on qualified activities without any further elaboration or breakdown. The information provided does not list—or even provide an estimate—of the employees' activities for the periods in question by project and by activity within the project or the employees' wages. Absent even this information, Business has not substantiated that it incurred the full amount of expenses claimed for the credit. However, for the items provided at hearing with Bates Stamps 0045 to 0073, inclusive, Business has

provided sufficient information to substantiate the time listed in that report, provided further that the activities were qualified research.

FINDING

Taxpayer is sustained on the expenses incurred in adding new features, integrating the features to its existing programs, determining the proper programming languages for the new features, and determining errors in the programs prior to the commercial release of the new versions of the programs. Taxpayer's protest is denied on other expenses.

Taxpayer's protest is denied with regard to the information provided for time spent on the projects, except for items provided at hearing with Bates Stamps 0045 to 0073, inclusive.

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